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FM AMEMBASSY ULAANBAATAR  
TO RUEHC/SECSTATE WASHDC 3086  
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UNCLAS SECTION 01 OF 04 ULAANBAATAR 000315

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E.O. 12958: N/A  
TAGS: EINV PREL ETRD EMIN ENRG MG  
SUBJECT: Key Mongolian Mining Deal Still On Track

Ref: A) ULAANBAATAR 293, B) ULAANBAATAR 244

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11. (SBU) SUMMARY: Three weeks into the Oyu Tolgoi Investment Agreement (OTIA) all parties seem committed to satisfying its conditions precedent. The companies have sent the first USD 100 million of a USD 250 million cash advance as promised while the Government of Mongolia (GOM) has honored its initial commitment to provide essential mining licenses. There is no indication that the parties will not fulfill other conditions of the agreement by the April 6, 2010, deadline. Public and business community opinions remain positive, as all see the project leading to increased prosperity. More problematically, it seems that neither the companies nor the GOM are preparing to deal directly with the fact that rising expectations cannot be met and with the administrative load that the mine will impose on an already strained system.

12. (SBU) On the foreign policy front, western countries continue to praise the agreement. Russia has remained largely silent and has given no indication that it will seek to hinder OT's implementation. China's response to OT remains unclear but no particular animus against it is perceived. Finally, although the PM's departure has raised concerns, as he was a primary supporter, there is no indication that the GOM will not continue to honor its OTIA commitments. END SUMMARY.

Three Happy Weeks

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12. (SBU) Three weeks after the Oyu Tolgoi Investment Agreement (OTIA) signing, all parties seem committed to satisfying the conditions precedent described in reftels. The most important condition, at least from the Mongolian perspective, was delivery of the first tranche of the USD 250 million cash advance. As reported

in Post's SBU blog (see [http://www.intelink.gov/communities/state/mon\\_golia](http://www.intelink.gov/communities/state/mon_golia)), the companies, Ivanhoe Mines of Canada and Rio Tinto (RT) transferred USD 100 million to the GOM within the two-week deadline. This money, the use of which remains undecided by the GOM, is not a grant but a financed advance, the principal and interest of which must be deducted from future government OT revenues. Even though it is a loan, a cash-strapped GOM eagerly proclaimed the first tranche a revenue-plus for Mongolia's citizens, who might expect some pocket money in the near future. The next tranche, USD 50 million, will come as soon as the GOM officially authorizes a 10 percent investment tax credit for the OT project. The remaining USD 100 million will arrive when construction of the mine complex begins, which is expected in August 2010.

¶13. (SBU) Ivanhoe and RT have expressed satisfaction with the pace of GOM fulfillment of the conditions precedent. On October 26, the GOM formally approved the conversion of several exploration licenses to mining licenses, as required by the OTIA. Canadian exploration company Entre Gold held these licenses, which surround the OT mining concession. They will be rolled into the OT project in 2010.

They are crucial because the OT deposit extends into these mining concessions. Without them, OT might have a mine life limited of 30 years; with them the mine may last up to 100 years, if some Ivanhoe sources are to be believed. Financing a long-life asset, especially one costing at least USD 7 billion to build, is easier than one of shorter duration, as the costs can be spread out over a longer period. The next step is for the GOM to extend the 10 percent investment tax credit to the OT project. Ivanhoe and RT suggest that the GOM action will occur by year's end. At this point none of the parties has signaled that this extension will be a problem.

¶14. (SBU) One area of contention remains: evaluating the amount of

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pre-deal costs that the firms can write-off under loss-carry forward provisions. The companies want to apply approximately USD 1 billion in expenses incurred to explore the mine and develop the mine site as business expenses against future taxes, while the GOM, already facing the fact that it will not be receiving revenues for many years, is loathe to delay receiving revenues from profits further trimmed by allowing a USD billion deduction. RT and Ivanhoe reps report that negotiations continue.

¶15. (SBU) The broad public response and that of the foreign and domestic business communities continues to be positive. Media sources and anecdotal evidence suggest that the Mongolian public sees the USD 100 million as proof that the OT deal will yield tangible benefits. For the business community, the entire temper of the Mongolian investment climate has improved dramatically. Although none reports an uptick in actual business (nor expects one within a few short weeks), foreign and domestic businesses are actively seeking contacts with the GOM and the private companies for business opportunities involved with OT.

¶16. (U) One local business association has developed an on-line "Mongolian Suppliers" resource featuring over 1150 local suppliers. On October 28, a supply chain fair sponsored by Ivanhoe, RT, and local business organizations hosted primarily local companies seeking to supply OT. Mining firms attending the event told us that they did not think most of the companies exhibiting were ready to supply OT quite yet. However, the event allowed RT and Ivanhoe to identify potential prospects and to explain their needs to potential suppliers more precisely. The GOM was satisfied as it actively seeks local value-added.

Reality Wake Up Call

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¶17. (SBU) While conceding these events as unambiguously positive, most GOM and company observers privately admit they are only just coming to terms with acute and chronic challenges imposed by the OT project. Among these are managing public expectations, dealing with the potentially overwhelming burden that OT will place on Mongolia's regulatory apparatus, and the impact on foreign relations with Mongolia's immediate neighbors. The Mongolian public has been led

by media statements of both the GOM and the firms to believe that the mine will start paying immense dividends immediately. Certainly the USD 100 million gives rise to such views.

However, Ivanhoe and RT reps have said that the mine will not begin operations until summer 2013 at earliest, with early 2014 being the likely start up date; and even then the GOM will receive little revenue from operations, as profits will go to pay off the GOM debt incurred to buy its share of the OT project.

18. (SBU) The GOM will receive royalty payments and other fees, taxes on salaries, and imposts on imports aimed at supporting the mine; however, RT and Ivanhoe sources privately suggest that mine profits may well be committed to debt payments until at least 2023.

However, both GOM and company sources indicate that they anticipate public discontent with the slowness of returns to surface long before then,, perhaps as early as 2012 with the next parliamentary elections. As of yet, it is not clear if the public understands the situation, and there seems no formal or informal plan among the parties to reconcile public expectations with revenue realities.

19. (SBU) Senior RT and Ivanhoe executives also express exasperation with Mongolian misinterpretation of their inter-corporate battle over the price that RT will pay Ivanhoe for its shares. RT expects to buy out Ivanhoe; and so, RT is busy trying to drive down the price of Ivanhoe shares while Ivanhoe is busy trying to drive share value up. While the strategies and tactics of these battles are familiar to western observers, the GOM and Mongolian public have no experience with such inter-corporate wars. For example, one of

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Ivanhoe's strategies is to bring in third party investors from wherever they can, including Chinese sovereign wealth funds. The aim here is to create a cadre of investors with a vested interest in maximizing share return. However, bringing in a Chinese buyer frenzies the Mongolian public and GOM, who, fearing that their two partners are preparing to sell out Mongolia to China, may slow down the OT project implementation. While acknowledging the existence of Mongolian concerns, the companies, who have expressed disdain to Post over what they consider Mongolia's lack of worldliness, have yet to craft an approach to mitigate Mongolian concerns.

10. (SBU) On the regulatory front, it has become increasingly clear that the GOM is not ready to administer OT's buildup, let alone its operation, and that this lack of capacity may well slow down development unless dealt with immediately. For example, the General Specialized Inspection Agency (GSIA) will have to approve up to 6000 thousand licenses and permits. However, it certainly lacks any expertise to assess the quality of the technology and work environment being created at OT, let alone the entire infrastructural platform that will support the project. In addition, the GSIA is staffed via a patronage system that allows for the firing of at least 60 percent of its staff every time it gets a new General Director, and it just so happens that a new General Director is set to be appointed this month. The lack of skill and a highly politicized employment scheme that values rewarding clientele more than serving public interest will impose real, ongoing bottlenecks on OT, just when smooth, professional permitting is essential. Short of the GOM allowing the companies to self-regulate, and being accused of ignoring its regulatory obligations, neither the GOM nor the companies have proffered a solution to this and other looming regulatory problems.

11. (SBU) The OT investment agreement does offer a solution that might ameliorate these problems to some extent. The deal requires the establishment of a council to mediate disputes among the parties. The GOM must nominate its members and a head of this body - one Ivanhoe exec called this person the OT Czar - within the next six months. The initial intention was for the council to serve as a dispute resolution entity dealing with permit and license delays. However, it has been suggested by company executives that the body might well expand its mandate to be the vehicle to deal with other problems arising from the OT project. So far there has been no discussion of this possibility outside the companies; nor have either the GOM or the firms moved to staff and operate the OT Council.

¶12. (SBU) Regarding the current impact of OT on Mongolia's foreign relations, three weeks have continued the parade of praise from western countries and relative silence from China and Russia. Other missions have been clear and consistent that the deal proves that Mongolia is a place where western firms can do business, even if in some investment climate areas, such as the lack of administrative transparency, Mongolia continues to fall short.

¶13. (SBU) Russia seems to have remained largely indifferent to OT, rumors to the contrary notwithstanding. In run up to the signing, newspapers reported that the Russians were furious with the GOM for signing the deal and would take vengeance on Mongolia. None of the articles explained why the Russians would be so miffed about OT. In the post-signing environment, we have heard little from official or unofficial sources suggesting any particular Russian animus against OT. Mongolian officials and company executives bluntly state the Russians have said and done nothing to hinder OT. Having received some commitments from the GOM regarding rail rights on the Tavan Tolgoi project, the Russians have taken no punitive action against Mongolia or any Mongolian politician or official - up to and

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including the lately resigned Prime Minister Bayar.

¶14. (SBU) The Chinese attitude remains opaque. China certainly desires access to Mongolia copper and seems no unopposed to having western firms intermediate between Mongolia and China. However, both the GOM and the companies are concerned that the Chinese will inhibit shipment of the mine's output in and through China, or use the state's monopoly control of smelters to force down Mongolia's price for OT's output. For their parts both RT and Ivanhoe state that they will have to come to some terms with the Chinese to ensure that the output can transit through China without undue state interference. RT and Ivanhoe are particularly concerned that RT's failed joint investment with the Chinese state-owned aluminum company Chinalco might prejudice the Chinese government against the OT project. Recent articles in the international press suggest that RT has begun a rapprochement with Chinalco and the Chinese government by offering such concessions as exclusive rights to market or to smelt the OT copper concentrate in China in return for ending outstanding disputes.

Bayar's Resignation and OT

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¶15. (SBU) The PM's resignation seems to have caught RT and Ivanhoe by surprise, as their local government affairs officials told them --and us -- categorically that the PM would remain in place. Our own review of the evidence led us to believe otherwise, and we conveyed our different view to the firms late last week, at least giving them a chance to start thinking about the post-Bayar era. RT, Ivanhoe, and other business sources expressed concern over Bayar's departure, because they believe that it was his commitment to push OT through the rough political waters that made the deal possible. Even though they -- and we -- believe the cabinet and whoever succeeds Bayar will remain committed to the OT project, the companies and other members of the domestic and foreign business communities worry that in the delicate period leading up to mine construction, Bayar's absence from the scene may allow adventurers in both political camps to play political hob with the project. They do take some solace from the fact that Bayar may remain as MPRP party chief and a Member of Parliament -- and so, would be available to enforce discipline on the coalition, assuming he is not too distracted by the medical condition that led to his resignation. In any case, the so-far smooth transition of power to a new PM, nominee Su. Batbold, along with the apparent stability of the coalition government, has dispelled initial fears for time being.

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